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Comments in Accountants' Reports

By H. L. WILSON

REPORTS of accountants on audit engagements usually contain, in addition to the financial statements, comments relating to the statements and to other pertinent matters. Although comments may conceivably not be included in some reports, such cases should be rare, for the execution of every engagement should develop some facts worthy of being communicated to the client in addition to the facts set forth in the financial statements. When the circumstances are such that it is inappropriate to render comments with the statements, comments may well be submitted as a separate report.

It is probably safe to say that the majority of accountants do not fully realize what an important feature of the report the comments can be made. Certainly many of them fail to make the comments of maximum interest and value to the client. To test this statement, select at random a dozen accountants' reports. Note how many are devoted very largely to a mere recital of the methods followed by the accountant in verifying the accounts. The reader of the report is not concerned with the technique of the accountant. He may not be interested in what the accountant did or did not do in the course of his work. But it may be a matter of very vital interest to the accountant to state what he did not do, as a precaution against having questions arise later as to his responsibility. The reader is interested in the accountant's findings. He wants to know that the accounts are correct, or, if not, wherein they are incorrect. He wants analytical and interpretative information about the financial condition and the results of operations of the business.

Nature of the Comments

The nature of the comments depends largely upon the purpose of the engage-

ment. If the work is being done for a prospective purchaser of the business, or for anyone not familiar with the company, it is well to give a short history setting forth the date of inception of the business, the capitalization and changes therein, and any other pertinent facts, such as a general description of the facilities owned by the company, its products, and marketing methods. If the report is being prepared for the use of bankers in connection with the flotation of securities or granting of credit, the comments should not deal with such matters as minor errors in book-keeping routine or deficiencies in the system of accounting. However, if the "situation" is such as to permit the perpetration and concealment of fraud involving a substantial amount, the facts should be conveyed to the reader of the report. The language used should be such as will not be offensive or slanderous.

The size of the business is another factor that has a bearing on the character of the comments. In the case of a large business, it is usually undesirable to comment in much detail on the verifications made by the accountant in executing the audit, or to furnish voluminous statistics relating to financial condition or operations. Details as to verifications made are uncalled for because those directing large concerns are generally familiar with the work of accountants and understand what to expect from them. Statistics and similar data may be out of place because such information is probably furnished them by their own organizations. The man at the head of a small business, on the other hand, is not so likely to be familiar with the work of accountants, and even if he has knowledge of accountants' services, he is apt to be interested in details. Usually, therefore, he would be glad to have an explicit statement of what work was done in executing the audit. Then too, such a client

generally is not in a position to obtain from his own staff all the information bearing upon his financial condition and operations which an auditor is able to give him.

The subject matter of the comments depends also upon the facts which are disclosed as a result of the audit. Those facts worthy of note should be brought to the attention of the client. What those facts are must be left to the judgment of the accountant in each case.

The whole point is that the comments should give the information that is needed in view of the purpose of the engagement.

Make the Comments Interesting

The accountant must make the report interesting if he wishes to be assured that the busy executive will read it. What could be more uninteresting than a report which reiterates, almost word for word, except as to the amounts involved, the wording of the preceding report rendered on the engagement. Yet this condition is often encountered in repeat engagements. Not infrequently mistakes are made as a consequence of this blind following of previous reports and of the assumption of the auditor that conditions have not changed, whereas they actually have changed. The accountant should, of course, read the report rendered on the previous engagement, but having done so, he should put it aside and write the current report independently.

The accountant should use imagination in the writing of the report, particularly in the interpretation of the facts brought out by the audit. But since accountants deal with facts and not fiction, imagination must be kept within bounds. However, there are always opportunities for the accountant to make his report a thing of vigor and a source of interest.

One way to add interest to the report is to state the most important things first. Instead of adhering to the hackneyed method of commenting on the various items in the order of their appearance in

the statements, why not begin by telling about the noteworthy things? Note the following opening paragraph:

"We counted the petty cash fund on January 19, 1928, and reconciled the balance with the amount shown by the books as of December 31, 1927, by adding to the former the disbursements, and deducting the receipts, for the intervening period."

Compare the foregoing with the following introduction:

"The improvement in the company's financial condition during the year is demonstrated by the following comparison of net current assets, and of the relation of current assets to current liabilities:

	January 1, 1927	December 31, 1927
Net current assets	\$324,500	\$612,250
Ratio of current assets to current liabilities	1¼ to 1	3 to 1

This improvement was accomplished not through additional financing, but solely through an increase in sales and a decrease in cost of production."

Which opening comment will be more likely to influence a busy executive to read on?

In a report upon a cash shortage, the salient points are the fact of the shortage and the amount involved. The most effective procedure is to place these vital facts first instead of withholding them until the close.

Arrangement of the Comments

While there is no fixed mould to be used in the arrangement of the comments, there are certain general rules which it is well to follow in cases which do not call for exceptional treatment.

In the case of engagements which do not involve a complete verification of the statements submitted, accountants have not infrequently become involved in serious

difficulties because they failed to make clear in the very beginning of the report the character of the engagement. Unless the limited character of the engagement is made known at the outset, the reader is likely to assume that the financial statements submitted have been fully verified. The reader would become informed of the restrictions—assuming that they were stated subsequently—if he read all the comments. But how many times have accountants found that those to whom their reports are rendered have contented themselves with an examination of the statements and little or no attention to the comments! It is important, then, to make clear at the outset of the report the character and scope of the work done. As an added precaution, the items in the statements which were not fully verified should either be so indicated, or else reference made therein to the qualifying comments.

Some reports are signed at the end of the presentation—the term given to the introductory paragraph of the report and the succeeding list of exhibits and schedules. In such cases the comments are submitted as a separate part of the report without signature. A better practice usually is to sign at the end of the comments. If the comments are presented over the signature, they are more likely to be read:

first, because there is then no break between the presentation and the comments, with the result that the reader is likely to continue after having read the presentation; and second, because to present the comments over the signature implies that they are of greater importance than would be implied if they were rendered unsigned.

The order of the comments proper depends upon the relative importance of the various aspects of the situation. If a history of the company is given, that may well be presented first—*i.e.*, immediately following the presentation—because such information is fundamental to a complete understanding of the story to be told in the report. After the historical information, it is usually well to present general comments on the financial condition and operations of the company. Then may follow detailed comments on the items appearing in the balance sheet, or such of them as call for comment, and, if desired, comments on system, organization, and personnel. Finally, general comments may be given bearing on such matters as insurance coverage, unfilled orders, commitments, etc. Of course, the foregoing is not intended as a fixed rule. The accountant must determine in each case the points to be given precedence.

(To be continued)

Our New Offices

THE firm announces that on May 1 its executive offices and the New York Broad Street practice office will be removed to the new Equitable Trust Building, 15 Broad Street.

The new building is in the heart of the financial district, opposite the New York Stock Exchange and adjoining the low and massive building of the banking firm of J. P. Morgan & Company. A wing of the building extends through to Wall Street on the east side of the Morgan building, so that there are entrances on Broad Street, Wall Street and Exchange Place.

The site is unique from a historical point of view. It was included in the area protected from savage raids from the north by the wooden stockade or wall built in the year 1653 by Peter Stuyvesant, which gave Wall Street its name. Later, in 1692, it became the site of the Dutch Reformed Church, the first church in Garden Street, as Exchange Place was then called. The "first church in Garden Street" survived the bombardments of the Revolution and the great fire of September 21, 1776, which destroyed Trinity Church and the buildings of the southern part of the city. Its reli-

contact, many of whom are experts in their own field.

In providing this background, a library is most useful. It is entirely possible for an accountant without any knowledge of cotton-growing, or the cotton manufacturing industry, to do a satisfactory piece of accounting work without ever having been inside a cotton mill or having any familiarity with the textile industry generally.

In the same way it is possible for an accountant to make an audit of a mining company without ever having been in a mine, if he will take the trouble, before going on an engagement of that character, to familiarize himself, from literature available, with the technology of mine operations. He need not be a mining engineer in order to pass judgment on the rationality of bases used for the valuation of mineral deposits, if he will consult the formulas afforded by books in his library. He need not admit of ignorance as to the adequacy of depreciation, if he will study the experience tables of depreciation rates contained in books on the subject.

In various ways the library serves the accountant. It gives him facts which he can use in the consideration of problems which come before him. It gives him information, without which he can scarcely do his work intelligently in modern practice. It gives him the benefit of thoughts of others, and the results of researches, which he has no time to make. In short, a library offers the accountant facilities for making of himself something more than a technical machine which functions automatically, regardless of the circumstances.

An efficient library, efficiently operated, is a service factor without which any successful service organization today cannot long continue. A library is dead timber, unless it is used.

The accountant who ignores his library is very likely, when a difficult special problem confronts him, to say, "It can't be done." The accountant who utilizes his library solves many a problem which the other fellow says can't be solved. "Know your library!"

Comments In Accountants' Reports

By H. L. WILSON

(Concluded)

FINANCIAL CONDITION AND RESULTS OF OPERATIONS

THE accountant can materially increase the value and interest of his report by including in the comments analytical and interpretative information regarding the financial condition and operations.

In many cases it is well to give in the comments a very condensed comparative balance sheet and a similar statement of operations. Such condensed statements enable the reader to grasp the situation much more quickly than he could from the detailed balance sheets and income statements submitted as exhibits. The comparative feature, too, has much value, for comparisons indicate the trend; it is even more important to know where one is going than

to know where one is. Comparisons may well be shown also in the financial statements presented as exhibits.

The financial condition frequently may be most effectively shown in the comments by departing from the customary form of the balance sheet and showing the facts as follows:

Current Assets:	
Cash.....	\$.....
Accounts receivable.....
Inventories.....
Total.....	\$.....
Less Current Liabilities:	
Notes payable.....	\$.....
Accounts payable.....
Accrued accounts.....
Total.....	\$.....

Net Current Assets.....(forward)	\$.....
Property (less reserves for depreciation)
Total.....	\$.....
Less Bonds and Mortgages.....
Net Tangible Assets.....	\$.....
Good-will, Patents, and Trade-marks...
Net Assets.....	\$.....
Represented by—	
Capital stock.....	\$.....
Surplus.....

the ratio of current assets to current liabilities may not indicate an entirely satisfactory tendency if it results from a large increase in inventories unaccompanied by a corresponding increase in sales. Similarly, a large increase in accounts receivable may not indicate an improvement in financial condition if the debtors are not responsible. Sometimes increases in sales are attained through unjustified relaxation of credit requirements.

In commenting on the financial condition of a company it is well to point out any striking changes, such as relatively large increases or decreases in working capital, in property, or in funded debt or capital stock.

Other interesting ratios are those showing the relation of each class of assets to the total assets, and of each class of liabilities to the total liabilities.

A statement of sources of funds and their disposition is given sometimes in place of a condensed comparative balance sheet. This statement shows, first, the funds which have come into the business in a given period (whether from profits, borrowings, capital contributions, or sale of assets), and second, the disposition of those funds (whether used in the acquisition of assets, the liquidation of liabilities, or the payment of dividends). This statement uses the same information as is given in a comparison of balance sheets, but presents the data in a manner which shows more clearly the inter-relation of the increases and decreases in the assets, liabilities, and capital.

As to the liability side of the balance sheet, these ratios indicate the proportion of the total capital used in the business which has been derived from current borrowings, from funded debt, from the sale of capital stock, and from surplus profits retained in the business. The proportions of these items vary considerably in different classes of business. In a railroad or a public utility, for example, one would ordinarily expect to find a larger proportion of the capital derived from bonded indebtedness than in an industrial. In general, the lower the ratio of the current liabilities and the higher the ratio of the capital stock and surplus, the more favorable the financial condition.

The use of ratios often helps to disclose weaknesses in financial condition and causes of unsatisfactory operating results. It is impossible to include in this article a full treatment of the subject of ratios, but a few of those most commonly employed will be discussed.

As to the asset side of the balance sheet, these ratios show the proportion of the capital invested in the various classes of assets. Over-investment in plant, inventories, or receivables is among the commonest of business ailments. Comparisons over a period of years of the ratios of amounts invested in these assets should aid in disclosing any tendency toward over-investment.

As to financial condition, the ratio of current assets to current liabilities is a significant percentage, and comparisons of such ratios as of two or more dates are doubly significant as establishing trends. In commenting on this ratio and on the variations therein, it is well to note the part played in the variations by increases or decreases in inventories. An increase in

Other ratios which aid in disclosing any tendency toward over-investment in assets, are those showing the relation of sales to each kind of asset. The higher the ratio of the sales, the more favorable, of course, is the showing. In the case of inventory it is preferable to use the ratio of the cost of sales (instead of sales) to the asset.

The ratio which is of commonest use in ascertaining the profitableness of a business is the ratio of net income to net worth. This ratio shows the rate of profit on the owned capital remaining in the business. In connection with this ratio it is sometimes well to show the amount of profit on each share of common stock. In stating this amount provision should be made, of course, for the preferred dividend, if there is preferred stock outstanding. In some cases it may be desirable also to show the book value per share of common stock. In computing this value, any capital surplus or appropriated surplus should be included. If there is a reserve for contingencies that is in effect merely appropriated surplus, obviously, that too should be included. To arrive at the book value of the common stock it is necessary to deduct any excess of the liquidation value of preferred stock over its stated value. This deduction may cause a decided decrease in the book value of the common stock if the preferred stock is without par value. In that case, stock having a liquidation value of \$100.00 a share might be carried at one dollar, or even less.

Constructive comments on the results of operations should bring out the salient factors that contributed to the result. A diminished profit might result from reduced sales, reduced selling prices, increase in one or more of the elements of manufacturing cost, increased selling, administrative, or other charges, or a combination of two or more of these factors. Increased material costs might result from increased prices of raw material or from decreased efficiency in the use of material. Increased labor cost might result from increased wage rates or from decreased productivity of labor. Increased overhead costs might result from increased expenditures or from reduction in the volume of production. The accountant may be unable, in view of the limitations of the scope of his work, to determine the precise causes of these phenomena, but he should have all the possibilities in mind, and when he cannot diagnose the trouble,

he may be able to suggest avenues of inquiry to be followed. Here, again, ratios are valuable. Ratios of cost, gross profit, expenses, and net income to net sales, and comparisons of such ratios over a period of years, help to localize expenses of disproportionate size and to show the trend.

When an increase in sales has not been accompanied by a proportionate increase in profit, it may be well to submit a statement showing what the cost, expenses, and profit would have been had the ratio thereof to sales been the same as for the preceding year. Assume, for example, that the operations for 1926 and 1927 were as follows:

	1926	%	1927	%
Net sales.....	\$100,000.00	100	\$150,000.00	100
Cost of sales.....	60,000.00	60	90,000.00	60
Gross profit.....	\$40,000.00	40	\$60,000.00	40
Selling expenses.....	\$15,000.00	15	\$30,000.00	20
Administrative expenses..	10,000.00	10	18,000.00	12
Total.....	\$25,000.00	25	\$48,000.00	32
Profit from operations...	\$15,000.00	15	\$12,000.00	8
Income charges (net)....	3,000.00	3	3,000.00	2
Net income.....	\$12,000.00	12	\$9,000.00	6

A comparison of the actual results with the results as they would have been had the ratio of cost and expenses to sales for 1927 been the same as for 1926, is as follows:

	Actual	%	Based on 1926	%
Net sales.....	\$150,000.00	100	\$150,000.00	100
Cost of sales.....	90,000.00	60	90,000.00	60
Gross profit.....	\$60,000.00	40	\$60,000.00	40
Selling expenses.....	\$30,000.00	20	\$22,500.00	15
Administrative expenses..	18,000.00	12	15,000.00	10
Total.....	\$48,000.00	32	\$37,500.00	25
Profit from operations...	\$12,000.00	8	\$22,500.00	15
Income charges (net)....	3,000.00	2	4,500.00	3
Net income.....	\$9,000.00	6	\$18,000.00	12

The reduction of \$3,000 (\$12,000 less \$9,000) in the actual profit for 1927 as compared with 1926 is made up as follows:

Increase in profit at 12% (1926 rate) on \$50,000.00		
increase in sales.....		\$6,000.00
Less:		
Excess of actual expenses over expenses based on 1926 ratios:		
Selling expenses.....	\$7,500.00	
Administrative expenses	3,000.00	\$10,500.00
Deduct—Reduction of actual income charges as compared with amount based on 1926 rates.....	1,500.00	9,000.00
Reduction in profit for 1927.....		\$3,000.00

Suggestions for improvement in the

presentation of comment material, such as are made herein, need to be accompanied by certain admonitions. Interesting comments may be constructed from interpretations of figures, but the interpretations must be based on facts, not on possibilities, nor imagination, and the conclusions must be sound. A safe rule to follow is one requiring that a comment not susceptible of proof shall not be put in a

report. In other words, the accountant should not make a positive statement in a report unless he is prepared to prove it in court. This strict requirement, rather than decreasing the amount of interesting comment material in reports, should result in better comments, because not only of the zest which the requirement adds, but of the conclusive and substantial character which the comments will have.

New Firm Members

We Have Pleasure in Announcing the Admission, on June 1, 1928, of the Following Five New Members of the Firm:

Mr. Bowman

FRANKLIN BOWMAN was born in Markham, Ontario, Canada, September 3, 1885.

Mr. Bowman's early accounting experience was obtained as a bookkeeper for a manufacturing company in Canada, during which time he passed the intermediate ex-



Franklin Bowman

amination for Chartered Accountant. In 1905, he became a resident of the United States, being employed as an assistant accountant by a Detroit firm of Chartered

Accountants. Two years later he came to New York to take up his studies at New York University School of Commerce, Accounts, and Finance, and for the next three years, while attending school in the evenings, he was employed by a New York firm of Certified Public Accountants. In 1910 he was graduated from New York University with the B. C. S. degree, and also passed the New York C. P. A. examination. He became a citizen of the United States in 1914.

Mr. Bowman was engaged as an assistant accountant by Haskins & Sells, on January 4, 1911, after he had shown his determination to become associated with the firm by repeated letters of application from 1907 to 1910. He advanced steadily as a member of the New York office staff, and was rewarded for his thorough and intelligent service by being appointed manager of the Detroit office, February 1, 1920. While manager of that office he was also granted the certificate of Certified Public Accountant by the State of Michigan. On August 1, 1921, he returned to the New York Broad Street office as assistant manager of that office, rising to manager on January 1, 1926, the position which he held on becoming a partner.

Mr. Bowman is a member of the American Institute of Accountants, and of the New York State Society of Certified Public Accountants.